87-494

No. 87-303

In The
Supreme Court of the United States
October Term, 1987

DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DEBENEDETTI, EMMETT R. DEMOSS, JR., SIMONE FUBINI, B. J. MEREDITH AND ELSERINO M. PIOL,

Petitioners,

—v.—

HANNAH FINKEL,

Respondent.

RESPONDENT'S CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTION PRESENTED

Is the fraud on the market doctrine applicable to a misrepresentation claim by a defrauded investor under Rule 10b-5(2) as well as to claims under 10b-5(1) and (3)?

PARTIES TO THE PROCEEDING

The caption of the case in this Court contains the names of all the parties to the proceedings in the court below.

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Respondent Hannah Finkel is the Plaintiff in this action. Respondent respectfully requests that a writ of certiorari issue to review that part of the judgment of the United States Court of Appeals for the Fifth Circuit which denies Respondent's right to recover under Rule 10b-5(2) based upon the fraud on the market doctrine.

OPINIONS BELOW

The Opinion of the Court of Appeals is reported at 817 F.2d 356 (5th Cir. 1987). It is set forth in the Appendix (1a-17a) to Petitioners' Petition For a Writ of Certiorari filed in these proceedings. Respondent incorporates by reference the Appendix in Petitioners' Petition, and all references to the Appendix herein are to the Appendix appearing in Petitioners' Petition. The Order of the District Court is unofficially reported at [1986-1987 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 92,944 (N.D. Tex. 1986). It is set forth in the Appendix (18a-19a).

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JURISDICTION

The judgment of the Court of Appeals was entered on May 27, 1987 (20a-21a). This Court has jurisdiction to review that judgment by writ of certiorari under 28 U.S.C. §§ 1254(1), 2101(c). This Cross-Petition is filed in reliance upon Supreme Court Rule 19.5. The Petition for certiorari in connection with which this Cross-Petition is filed was received on August 25, 1987.

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STATUTE AND RULES INVOLVED

The statute and rules involved in this proceeding are Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Securities and Exchange Commission

Rule 10b-5, 17 C.F.R. § 240.10b 5. They are set forth in the Appendix (22a-23a).

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STATEMENT OF THE CASE

Petitioner Docutel/Olivetti Corporation ("Docutel") is a Delaware corporation with executive offices in Irving, Texas. On October 1, 1983, Docutel had issued an outstanding 6,800,000 shares of Common Stock owned by more than 3,200 shareholders. Docutel's shares were traded in the over-the-counter market. Petitioner Ing. C. Olivetti & C., S.p.A. ("Olivetti") is an Italian corporation with its executive offices located in Italy. Olivetti acquired practical control of Docutel by means of merger between a subsidiary of Olivetti and Docutel, and the issuance of a warrant by Docutel to the Olivetti subsidiary. Petitioners B. J. Meredith and Emmett R. DeMoss were, respectively, the chief executive officer and executive vice president and chief financial officer of Docutel.

Petitioners DeBenedetti and Simone Fubini were respectively the chief executive officer and chief operating officer of Olivetti. Petitioner Elserino M. Piol was a representative of Olivetti who acted as a director of Docutel.

On December 5, 1983, Mrs. Finkel purchased 300 shares of Docutel on the public market at $14 5/8 per share, for a total price of $4,474.75.

On April 12, 1984, Mrs. Finkel filed a Class Action Complaint (24a-32a) alleging that the quarterly earnings

of Docutel reported throughout 1983 were substantially overstated, and losses were understated, by reason of the failure of Docutel and Olivetti as its controlling shareholder, and their respective officers, to charge off worthless inventories acquired from Olivetti and its subsidiary. The Complaint alleges violations of subdivisions (1), (2) and (3) of Rule 10b-5.

Plaintiff relied upon the integrity of the public market for Docutel shares in making her purchases, and thereby incurred losses by paying the artificially inflated public market prices resulting from the fraudulently overstated earnings.

On February 16, 1984, Docutel announced that it projected a net loss for the year ended December 31, 1983, in the amount of $14,000,000. On April 2, 1984, *The Wall Street Journal* reported that Docutel said its previously projected net loss for 1983 of $14,000,000 was "significantly" wider. In its 10-K for 1983 Docutel reported an after-tax loss of $18,263,000 for 1983. The loss included $10,900,000 of inventory writedowns, approximately $10,100,000 of which was recorded in the fourth quarter. Significantly, Docutel made the following admission in its 1983 Form 10-K:

> In 1983, the Company's record keeping procedures and accounting staff were strained due to the significant growth in transaction volume resulting from the merger with Olivetti Corporation, attrition of personnel, and the transfer in the second half of 1983 of the OPD accounting function from Tarryton, New York, to the Company's headquarters in Irving, Texas.

Docutel's stock plummeted from a high of $38-7/8ths in 1983 to a closing bid price of April 6, 1984, of $7-1/4, causing public inventors to take large losses.

Petitioners moved to dismiss the complaint under Fed. R. Civ. P. 12(b)(6) for failure to plead individual reliance on the alleged misleading statements, and under Fed. R. Civ. P. 9(b) for failure to plead fraud with particularity. See 817 F.2d at 358; (4a). The district court deferred discovery and class certification pending a decision on the motion. Id.; (4a). On August 20, 1986 District Judge Robert B. Maloney dismissed the complaint for failure to plead individual reliance. (18a-19a).

Mrs. Finkel filed a notice of appeal on September 17, 1986. In an opinion dated May 27, 1987 the Fifth Circuit affirmed in part and reversed in part. The Court held that reliance on alleged misstatements is required under SEC Rule 10b-5(2) and affirmed the dismissal of the claims under Rule 10-5(2). The Fifth Circuit noted that its holding dismissing the Rule 10b-5(2) claims was in direct conflict with those of other Circuits that permitted "fraud on the market" reliance for Rule 10b-5(2) claims. 817 F.2d at 362-63 & n.17; (12a-13a).

The Court went on to hold that reliance is unnecessary under Rule 10b-5(1) and Rule 10b-5(3) for a "fraud on the market" claim alleging non-disclosures. 817 F.2d at 362-63; (12a-13a). The court found that the complaint alleged a case falling within Rules 10b-5(1) and (3). 817 F.2d at 363; (14a). The Court therefore reversed the district court and reinstated the complaint for claims under Rule 10b-5(1) and (3).

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REASONS FOR GRANTING THE WRIT

The Fifth Circuit stands alone as the only Court to reject application of the fraud on the market doctrine to misrepresentations under Rule 10b-5(2). In reaching its conclusion, the Fifth Circuit has erected a semantic road block to just claims by public investors which frustrates the clear intent of Congress in enacting the securities laws in order to enable defrauded investors to recover their losses without overcoming the technical hurdle of reliance developed by the common law in the context of claims arising out of face-to-face transactions instead of the impersonal securities markets.

The Fifth Circuit has elevated the ephemeral distinctions between misrepresentations and omissions to the linchpin of recovery in securities actions. Every misrepresentation involves to some degree an omission, just as every omission involves to some degree a misrepresentation. The facts of this case provide a good example. Docutel misrepresented its earnings by omitting to state that inventories had been artifically inflated by paying excessive prices for worthless inventories acquired from affiliates. However, other fact situations will not be so clear, and investors in some cases will be denied any recovery for their losses by reason of the fact that one court may interpret the principal thrust of a fraudulent scheme to be a misrepresentation, instead of an omission.

The intent of Congress should not be easily frustrated by such fine distinctions. Fraudulent managements will vigorously urge that their frauds were accomplished prin-

cipally through misrepresentations, rather than omissions, in order to avoid any liability. Much time and efforts of the Courts will be consumed in considering the metaphysical distinctions between misrepresentations and omissions. The Fifth Circuit's unique proposed dichotomy overlooks the practical aspects of modern securities markets.

The distinction urged by Petitioners upon this Court constitutes a blueprint for successful securities frauds. Fraudulent managements need only limit their fraudulent misrepresentations to such filings as 10-Qs and 10-Ks. These SEC filings are typically analyzed only by market professionals. Professional analysts will then formulate recommendations based upon the SEC filings. Brokers will pick up the analyst recommendations, and recommend the stock to their public investor customers. The overstated earnings and assets will lead to a consistently rising stock price, which brings all kinds of benefits to management, including profits on stock holdings, profits on stock options, public financings, and increased salaries and bonuses.

All of these benefits are of course acquired at the expense of the defrauded public investors, but since such investors' reliance is only indirect, the public investors will be precluded from recovery upon these facts under the Fifth Circuit's rule if the Court finds that the fraud was accomplished principally through a misrepresentation. A public investor could protect his rights to sue for fraud only by the totally unrealistic procedure of reviewing all SEC filings and other public pronouncements by a company prior to investing in its shares.

The foregoing scenario could only serve to create public distrust in the securities markets, and lead to the illiquidity which the securities laws were specifically designed to prevent. Even Petitioners admit in their Petition that "[E]veryone who buys or sells securities in any transaction, whether face-to-face or on the open market, relies on the assumption that the price is free from fraud." Petition at 10. The assumption of market integrity is totally violated if an investor must have knowledge prior to investing of the specific misrepresentations which infect the market with the virus of fraud.

I. The Decision Below Is In Direct Conflict With The Decisions of Other Circuit Courts And With Decisions Of This Court

A. Conflict Within the Circuits

Petitioners concede in their Petition (at 15-19) that the Fifth Circuit's decision in requiring reliance in Rule 10b-5(2) cases, while excusing it in Rule 10b-5(1) and (3) cases, is in conflict with decisions of other circuit courts. However, since Petitioners *benefit* from denial of the right to claim under Rule 10b-5(2) only if individual reliance be pleaded and proved, Petitioners have no standing to assert the conflict as the basis for this Court's jurisdiction. (See Respondent's Brief in Opposition). Further, Petitioners assert the conflict in order to overturn the Fifth Circuit's ruling that no individual reliance is required in order to claim under Rule 10b-5(1) and (3), while the true vice in the decision is the distinction which the Fifth Circuit attempts to make in limiting claims for misrepresentation to only those claims in which individual reliance can be proved.

The Fifth Circuit recognized that its decision requiring reliance for Rule 10b-5(2) claims conflicted with decisions of other Circuit Courts of Appeals:

> We hold . . . that *Shores* permits a plaintiff to assert a fraud on the market theory under 10b-5(1) and (3) but not under 10b-5(2). . . . Other Circuits have gone even farther, and recognize the fraud on the market theory under 10b-5(2). We do not because *Shores* does not.

817 F.2d at 362-63; (12a-13a) (footnotes omitted) (citing *Peil v. Speiser*, 806 F.2d 1154, 1162-63 (3d Cir. 1986); *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985); *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). Indeed, the Fifth Circuit expressly disagreed with the 11th Circuit's interpretation of *Shores v. Sklar* that permitted fraud on the market claims in Rule 10b-5(2) cases. 817 F.2d at 363 n.18; (13a).

The Fifth Circuit's decision also conflicts with the Third Circuit's decision in *Peil*, which expressly declined to draw a distinction between fraud on the market claims brought under Rule 10b-5(2) and those brought under Rule 10b-5(1) and (3). According to *Peil*, "A single misrepresentation or omission, like a more widespread scheme, may artificially inflate the price of a stock and thus defraud plaintiffs who rely on the price of the stock in deciding to purchase shares." 806 F.2d at 1162 (citation omitted). *Peil* thus permits someone alleging even a single misrepresentation in a disclosure document to state a claim under rule 10b-5(2), even if the investor did not see or in any way rely on the alleged misrepresentation. *Id.* at 1163.

The extent to which the Fifth Circuit decision denying application of the fraud on the market doctrine to Rule 10b-5(2) claims is out of step with the virtually unanimous body of authority becomes evident by reviewing the following chart of circuit court opinions which have adopted the doctrine without making the distinction proposed by the Fifth Circuit:

CIRCUIT COURT OPINIONS
THAT HAVE ADOPTED THE
FRAUD ON THE MARKET DOCTRINE

CIRCUIT	OPINIONS
2nd Circuit	*Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976, 97 L.Ed.2d 75 (1975).
	Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981), *vacated as moot sub nom. Price Waterhouse v. Panzirer*, 459 U.S. 1027, 103 S.Ct. 434, 74 L.Ed.2d 594 (1982).
3rd Circuit	*Peil v. Speiser*, 806 F.2d 1154 (3rd Cir. 1986).
6th Circuit	*Levinson v. Basic Inc.*, 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 107 S.Ct. 1284 (Feb. 23, 1987) (No. 86-279).
7th Circuit	*Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 529 (7th Cir. 1985).
8th Circuit	*Harris v. Union Electric Co.*, 787 F.2d 355 (8th Cir. 1986).
9th Circuit	*Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976).
	Arthur Young & Co. v. United States District Court, 549 F.2d 686 (9th Cir. 1977).

Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979).

10th Circuit *T. J. Raney & Sons, Inc. v. Fort Cobb Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 104 S.Ct. 1285, 79 L.Ed.2d 687 (1984).

11th Circuit *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 83 L.Ed.2d 807 (1985).

D.C. Circuit *Wachovia Bank & Trust v. National Student Marketing Corporation*, 650 F.2d 342, 358 (D.C. Cir. 1980), *cert. denied*, 101 S.Ct. 3098 (1981).

B. Conflicts With This Court's Decisions

While this Court has not expressly considered the fraud on the market doctrine, this Court has recently denied certiorari in *Lipton v. Documation, Inc.*, 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 469 U.S. 1132 (1985), which squarely presented the question under the same circumstances as presented in this proceeding.

This Court has granted certiorari in *Levinson v. Basic, Inc., supra*, but the facts in *Basic, Inc.* are very different. First, as admitted by Petitioners, *Basic, Inc.* raises the issue in the context of class certification under Fed.R.Civ. P. 23(b)(3). The standard of review is abuse of discretion. In this case, the issues arise under a Fed.R.Civ.P. 12(b)(6) motion to dismiss, presenting a pure question of law. Thus, these cases are to be reviewed under differing standards.

Second, *Basic, Inc.* does not distinguish between causes of action stated under 10b-5(1) and (3), and causes of action stated under 10b-5(2). *Basic, Inc.* considers ma-

terial misrepresentations in public statements relating to the existence of merger negotiations. There is no issue as to a scheme to defraud or course of business that operated as a fraud. *Basic, Inc.* is primarily a 10b-5(2) case. This case on the other hand hinges on a scheme to defraud or course of business to defraud in violation of Rule 10b-5(1) and (3).

Further, *Basic, Inc.* presents questions of whether *sellers* may utilize the fraud on the market doctrine as well as *purchasers*. This issue is not presented on this appeal.

In a very analogous situation involving a misleading proxy statement, this Court held that proof of materiality of a misrepresentation is sufficient without proof of individual reliance. *Mills v. The Electric Auto-Lite Co.*, 396 U.S. 375, 285 (1970). In *Mills* this Court rejected the argument that a plaintiff should be required to prove that the proxy statement had a decisive effect on the vote. So long as the misstatements were material, and the proxy solicitation was an "essential link" in effecting the merger, this Court held, "a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress . . .", 396 U.S. at 385. Such a result, the Court said, "will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of insuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions" *(Id.)*.

This Court has "repeatedly . . . emphasized . . . that implied private actions [under Rule 10b-5] provide 'a most

effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to commission action.' " *Bateman Eichler, Hill Richards, Inc. v. Berner,* 472 U.S. 299, 310 (1985), (quoting *J. I. Case v. Borak,* 377 U.S. 426, 432 (1964)).

There clearly should be no distinction between Rule 10b-5(2) on the one hand, and 10b-5(1) and (3) on the other, arising out of the technical reliance requirements to establish the classic tort of deceit. As this Court has held, "[T]he typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable." *Herman & MacLean v. Huddleston,* 459 U.S. 375, 388 (1983) (*quoting Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 744-45 (1975).

"[T]he antifraud provisions of the securities laws are not co-extensive with common-law doctrines of fraud. [Citation omitted] Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry." *Herman & MacLean,* 459 U.S. at 388-89.

The right of a defrauded investor to recover must not rise or fall depending upon the often gossamer fine distinctions between misrepresentations and nondisclosures. As this Court recently emphasized in *Herman & MacLean,*

> "[W]e have repeatedly recognized that securities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.' " 459 U.S. at 386-87 (quoting *SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 195 (1963).

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CONCLUSION

There is no logical reason to require a defrauded investor to prove as a condition for recovery that his loss resulted more from an omission than a misrepresentation. So long as the investor proves that there is a causal connection between a fraudulent misrepresentation and his loss by proving materiality, those who perpetrate fraud should not be able to benefit by proving that their fraud was accomplished more by means of misrepresentations under Rule 10b-5(2) than non-disclosures under Rule 10b-5(1) and (3).

Respectfully submitted,

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APPENDIX

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